



Dean Schultz
President and
Chief Executive Officer

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Alfred M. Pollard
General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street, N.W.
Washington, D.C. 20552

VIA FEDERAL EXPRESS
AND EMAIL

Attention: Comments/RIN 2590-AA01

Re: Proposed Rulemaking on Minimal Capital

Dear Mr. Pollard:

The Federal Home Loan Bank of San Francisco (“San Francisco Bank”) appreciates the opportunity to comment on the Federal Housing Finance Agency’s (“Finance Agency”) proposed rule establishing standards for imposing temporary increases to the minimum capital requirements (the “Proposed Rule”) applicable to the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation (together, the “Enterprises”) and the Federal Home Loan Banks (“FHLBanks”; and together with the Enterprises, the “Regulated Entities”). The San Francisco Bank offers the following comments aimed at shaping a Final Rule that better protects the investment of the FHLBanks’ members and shareholders, while still ensuring that the FHLBanks are adequately capitalized.

I. Notice Requirements under Section 1225.3 and Review of Temporary Increase under Section 1225.4(c)

Under the Proposed Rule, the Director would provide an FHLBank with thirty (30) days advance notice of the effective date of any temporary increase in that FHLBank’s required minimum capital level. An FHLBank would then have fifteen (15) days to provide the Finance Agency with comments or objections to the temporary increase. The Proposed Rule provides that these time periods may be shortened even further if the Director determines that exigent circumstances exist. The San Francisco Bank believes that these time periods for response and compliance with respect to something so fundamentally critical to a Bank as its capital level are unrealistically short in light of the possible strategic financial management changes and other actions an FHLBank may need to take in order to meet the increased requirement. To carefully plan, implement and maximize the financial and economic benefit of certain strategic actions, such as an asset/liability restructure or further retained earnings buildup, an FHLBank is likely to need more than one month in the business cycle. In addition, if an FHLBank has to resort to a capital call from its members in order to comply, the FHLBank would need to comply with the additional relevant notice periods in its capital plan.

For these reasons, we believe that under normal circumstances, for purposes of the Final Rule, a notice period of at least 60 days, with at least 30 days to respond, is more appropriate. In addition, the Finance Agency should make clear in the Final Rule that the effective date of any required increase in minimum capital will take into account an FHLBank’s compliance with the terms of its capital plan (including any applicable notice periods). In any event, any order by the Finance Agency to increase the minimum capital level of any FHLBank should be subject to more formal administrative procedures for review by the Agency,

such as the procedures set forth in 12 CFR Part 907, including an opportunity to have a hearing on the proposed increase and an adequate amount of time to respond.

Finally, the Proposed Rule also requires that the Director review the decision to impose additional capital requirements at least every 12 months and permits the affected Regulated Entity to request a review of the decision at any time. To assure greater predictability, order and discipline in that process, the Final Rule should address the Finance Agency's procedures for conducting and responding to any requested review.

II. Standards for Imposing Temporary Increase in Minimum Capital

Section 1225.4(a) of the Proposed Rule establishes various standards and factors that the Director may consider in determining whether to impose temporary minimum-capital increases on a Regulated Entity. The San Francisco Bank believes that the proposed standards or factors identified below, in particular, should be clarified to improve their usefulness as indicators of an FHLBank's financial health or risk of failure.

A. Current or anticipated declines in the value of assets held

Section 1225.4(a)(1) of the Proposed Rule provides that current or anticipated declines in the value of assets held by a Regulated Entity may be used as a factor in increasing minimum capital requirements, but such declines may not always be an accurate indicator of a particular asset's underlying economic value. At any given time, asset values may be subject to temporary illiquidity or market volatility. As such, depending upon the asset type and specific asset characteristics, current or anticipated declines in asset values could be brief and might not represent any material risk to the financial health of the Regulated Entity. Recovery in the value of an asset could also occur rapidly. The risk of imposing an increase in temporary minimum capital requirements during periods of temporary illiquidity or market volatility could be harmful to an FHLBank and to its membership, depending upon member sensitivity to reduced dividends, captive capital, and possible additional capital calls. The Finance Agency should consider clarifying the nature and magnitude of the decline in the value of assets that would warrant an order to temporarily increase minimum capital levels.

B. Compliance with regulations, written orders, or agreements

Section 1225.4(a)(4) of the Proposed Rule says that the state of a Regulated Entity's compliance with regulations, written orders or agreements may be used as a factor. The San Francisco Bank believes that it is reasonable to consider this factor in determining whether higher minimum capital levels are warranted, but only if the non-compliance with regulations, written orders or agreements is material and negatively impacts the Regulated Entity's financial health or is indicative of such institution's potential risk of failure. As such, the Final Rule should make it clear that the relevance and magnitude of a Regulated Entity's non-compliance will be taken into account.

C. Housing finance market conditions.

The housing finance market conditions factor set forth in Section 1225.4(a)(6) of the Proposed Rule should be deleted. In addition to being vague, the relevance of this factor to a Regulated Entity's capital level is unclear, except to the extent that housing finance market conditions result in a decline in the

value of housing-related assets held by the FHLBanks. That situation, however, is already covered by Section 1225.4(a)(1) of the Proposed Rule.

D. Level of reserves or retained earnings

The Proposed Rule says that the Director may consider the level of reserves or retained earnings as a factor in requiring a temporary increase in a Regulated Entity's minimum capital under Section 1225.4(a)(7). The San Francisco Bank believes that this factor should be expanded to ensure that, in addition to considering reserves and retained earnings in determining a Regulated Entity's financial health, the Finance Agency is recognizing the Regulated Entity's demonstrated commitment and actions toward building retained earnings, and also is taking into consideration the aggregate capital levels of the Regulated Entity, which provides a more accurate indication of a Regulated Entity's health or risk of failure.

E. The ratio of market value of equity to par value of capital stock

Section 1225.4(a)(9) of the Proposed Rule would allow the Director to consider the ratio of the market value of an FHLBank's equity (MVE) to the par value of its capital stock (PVCS) as a factor in requiring an FHLBank to increase its minimum capital. However, as a preliminary matter, the San Francisco Bank believes that any consideration of using an MVE/PVCS ratio as an indication of the capital adequacy of an FHLBank should take into account the effect of combining it with other, similar uses of such ratio. For example, the existing risk-based capital regulation already imposes an additional risk-based capital charge on any FHLBank that has a market value of total capital less than 85% of the book value of its total capital, so that using an MVE/PVCS ratio to impose an additional increase in an FHLBank's minimum capital requirement would have the effect of "double charging" that FHLBank on the basis of the same criteria.

In addition, the Proposed Rule does not define "market value of equity." If the Agency determines MVE with reference to liquidation value, then we do not believe that such a measure provides a sound basis for increasing an FHLBank's minimum capital level. Market conditions in the recent past revealed the distortions that may result from using MVE as a measurement of capital adequacy. The industry saw MVEs driven lower by discounts in securities prices that did not reflect real interest rate risk and that overstated credit risk. Instead, we encourage the Finance Agency to develop an MVE model that reflects certain going concern assumptions and makes MVE determinations in the context of other factors, including market conditions.

Finally, the Proposed Rule establishes no parameters or standards for the Finance Agency to use in applying this ratio. There's no indication, for example, at what level(s) the Director would consider it appropriate to increase an FHLBank's minimum capital requirement based on this ratio. Conversely, if such an order is already in place, what level would this ratio have to achieve before the Director concludes that the order imposing a temporary increase in minimum capital levels should be rescinded? While the Finance Agency may not want to establish a bright-line threshold below which this factor would be triggered, the Finance Agency could help reduce the uncertainty surrounding these standards and measures by addressing in the Proposed Rule such critical issues as the size of a fluctuation that would weigh significantly in favor of the issuance or rescission of a temporary order.

F. Other conditions as detailed by the Director

Section 1225.4(a)(10) of the Proposed Rule provides that the Director may use other factors in making his determination, as long as they are detailed in the notice to the affected FHLBank. The FHLBanks and their members benefit from having as much certainty as possible regarding when, and under what conditions, an FHLBank's capital requirements may be increased. For greater certainty and stability in the System, the Final Rule should describe the types or relevant categories of "other factors" that the Director may consider in support of a decision to require a temporary increase in an FHLBank's minimum capital level. We suggest that factors other than those enumerated in the Proposed Rule should be used only in exigent circumstances, limited to situations where an increase is required for the safety and soundness of the FHLBank, where an FHLBank's failure is imminent, or where the capital situation at a particular FHLBank puts the System in jeopardy, and that they be used only on a temporary basis subject to the Finance Agency engaging in its normal public comment process around regulatory changes.

III. Promulgation of Future Guidance

Section 1225.4(d) of the Proposed Rule provides that the Finance Agency may issue guidance regarding the Proposed Rule from time to time "to elaborate, to refine or to provide new information regarding standards or procedures contained [in this regulation]." To the extent that guidance expands or adds substantive detail to the existing regulation, it would be better for the guidance to be issued as a formal rulemaking and subject to the requirements of the Administrative Procedure Act, with advance notice and an opportunity to comment by the FHLBanks and their members. This is particularly important to FHLBank members, since actions taken under the Proposed Rule and any subsequent guidance could have significant financial and accounting implications for them.

IV. Conclusion

Again, we thank you for the opportunity to provide comments on this important matter for the FHLBanks and their member-shareholders. While we believe that this Proposed Rule is necessary and important, we urge you to consider the comments in this letter and revise the Final Rule to address our concerns.

Very truly yours,



Dean Schultz
President and Chief Executive Officer

cc: L. B. MacMillen
S. Titus-Johnson